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European Review

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2 January 1985

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*EUR ER 85-001
2 January 1985*

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European Review

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West German Views on MBFR [REDACTED]
[REDACTED]

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During the last round of the Mutual and Balanced Force Reduction (MBFR) talks, objections from the West Germans prevented the West from presenting the East with a new proposal. We think that Bonn is reviewing its approach to the talks and may want to restructure the Western position. [REDACTED]

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Obstacles to Growth [REDACTED]
[REDACTED]

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West German manufacturers have sustained losses in competitiveness over the past decade or so as a result of sluggish investment, slower productivity growth, and tardy adaptation to changing markets, especially in the high-technology sectors. While we expect West Germany to retain its standing as a major economic power behind the United States and Japan, the technological and structural gap will not be closed soon, and West Germany will have a hard time maintaining market shares at home and abroad. [REDACTED]

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Restructuring the Steel Industry [REDACTED]
[REDACTED]

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The planned merger between Kloeckner-Werke and Krupp, West Germany's second- and fourth-largest steel companies, is the first step toward a much needed consolidation of Western Europe's largest national steel industry. While backing Bonn's opposition to EC steel subsidies, the West German steel industry will demand matching subsidies if the influx of subsidized steel imports continues beyond next year. The Kohl government, however, is likely to continue free market policies—pushing restructuring and shunning mass subsidies and protectionism. [REDACTED]

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One Analyst's View

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Economic News in Brief31

Some articles are preliminary views of a subject or speculative, but the contents normally will be coordinated as appropriate with other offices within CIA. Occasionally an article will represent the views of a single analyst; these items will be designated as uncoordinated views.

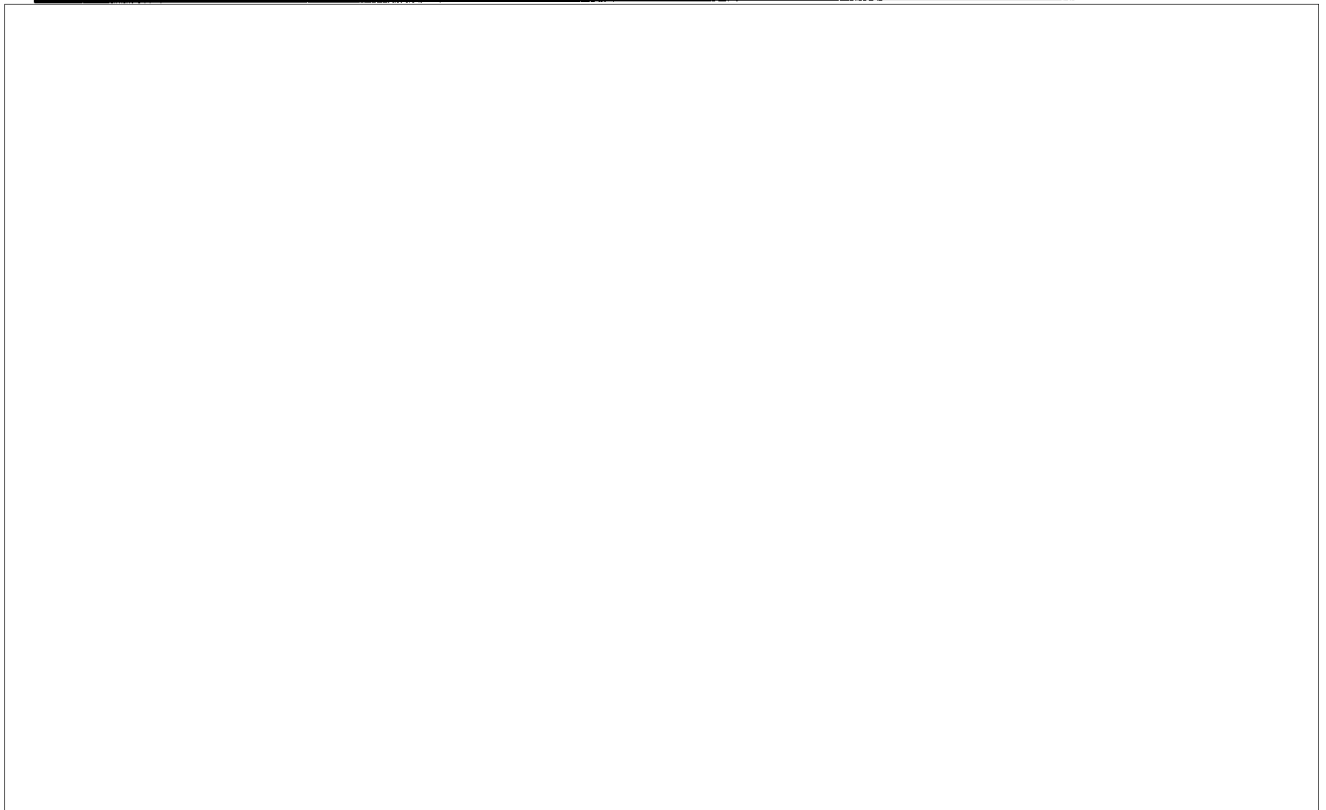
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Briefs

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**Sweden-USSR****Negative Public Attitudes Toward the Soviets**

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A recent Swedish Government opinion poll revealed increasing public suspicions of Moscow's policies. Eighty-six percent of respondents considered Soviet intentions either unfriendly or directly threatening toward Sweden—the highest negative response ever recorded by this yearly survey. In addition, the poll demonstrated increasing public concern about Sweden's defenses and support for defense spending.

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The US Embassy in Stockholm notes that deterioration of the Soviet public image in Sweden coincides with highly publicized Soviet violations of Swedish airspace and sea space since 1981. Recent public Soviet complaints that Sweden is moving toward the West may have strengthened public perceptions of Soviet interference in Swedish affairs.

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Swedish Perceptions of the Soviet Union

	Threat	Unfriendly	Not Unfriendly	Friendly
1984	38	48	9	2
1983	37	43	14	1
1982	32	41	21	3
1980	12	24	45	11
1973	4	15	57	18

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Austria-Czechoslovakia**Continued Tension Over Border Incident**

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Vienna is maintaining its tough stand toward Czechoslovakia over the death of a refugee, who the Austrians claim was shot by Czechoslovak border guards in Austrian territory. The Sinowatz government earlier postponed a series of cultural and diplomatic exchanges, and Foreign Minister Gratz has now demanded an apology from Prague, as well as bilateral discussions to improve border conditions. Austria believes that its position as a neutral allows it to pursue human rights improvements in Central Europe—in addition to a reduction in East-West tensions—and Vienna long has prided itself on its role as a haven for refugees. Vienna is likely to continue its tough line.

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The Czechoslovaks also are unlikely to move soon to return relations to a more cordial footing, even though they have returned their Ambassador to Vienna who had been recalled to protest Austrian reaction to the incident. Austria's relatively high standard of living and good international standing have long irritated the Czechoslovak regime because of the unfavorable comparison they offer for its own population. Prague has also been annoyed by Vienna's liberal human rights policies and its sheltering of refugees and opponents of the Czechoslovak Government, which give rise to accusations that Austria violates its neutrality. The Czechoslovak media consequently have continued attacks on Austria for mounting "a hate campaign" and turning bilateral relations back to the "ice age."

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Hungary**Studying Wage Differentials**

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A recent survey of income distribution in Hungary suggests that growing inequality between social classes has been encouraged by Budapest's consumption and reform policies over the past several years. An Hungarian sociologist found that about 19 percent of the population—mostly senior citizens and gypsies—live below the socially acceptable minimum wage, while the wealthiest 8 percent are predominantly those who can generate large incomes in the private sector. Informal interviews of the man on the street by US Embassy officers support the

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study's conclusions and also indicate that a family often needs the salaries of two adults in order to live comfortably. []

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Recently, the Hungarian press has been replete with debates about the equity and social consequences of the emerging rich class at a time when austerity measures are cutting real wages for many other workers. Sociologists also are concerned about the negative impact on family relations and population growth of long afterhours work at private activity and large-scale participation of women in the work force. Although the leadership continues to defend private enterprise as improving the efficiency of production and the volume and variety of consumer services, [] the government is studying ways to make the tax system more equitable for white-collar employees and those industrial workers who lack access to extra income. Budapest also is faced with formulating austerity measures and economic reforms—for example, reducing subsidies on consumer goods and public services and decentralizing price formation—in ways that do not put undue burden on the least fortunate income groups. []

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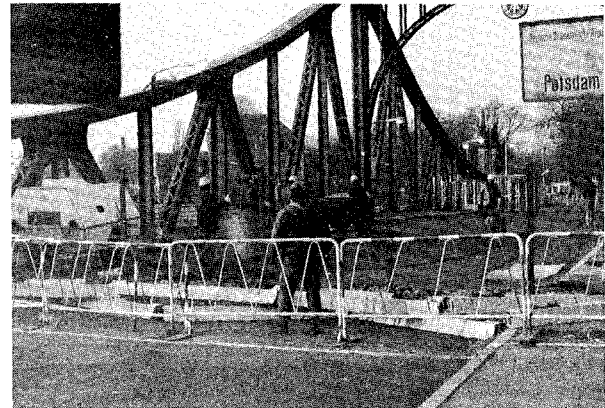
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Challenges to the Western Position in and Around Berlin

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Last year the Soviets and East Germans took a series of actions in and around Berlin that impinged adversely on the Allied position by further eroding Western rights under Four Power agreements. In December, however, they took steps apparently designed to defuse Western protests and avoid the appearance of an East-West confrontation over Berlin. This new demonstration of flexibility may have been timed to influence Allied discussions of Berlin issues at the NATO ministerial meeting late last month. It may also reflect increasing Soviet interest in smoothing over secondary disputes with the United States in anticipation of the meeting between Secretary Shultz and Foreign Minister Gromyko this month. On balance, the Western position in and around Berlin is not as good as it was a year ago.



East Germans remove barricade at Glienicker Bridge on 15 November 1984.

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Challenge to the Allies

The actions taken last year involved technical matters and have antecedents in earlier disputes, but, taken collectively, they could be interpreted as an effort to demonstrate Western vulnerability in Berlin at a time of heightened East-West tension:

- On 20 February, the Soviets launched their most serious challenge to quadripartite management of the air corridors in recent years by unilaterally announcing that henceforth all Soviet temporary reservations of airspace in the corridors would cover the entire length of the corridors. Previously, they had only requested reservations for part of the corridors. Although the new restrictions have not reduced the number of Allied air flights to Berlin, they have, in the view of Allied authorities, created a safety hazard.
- On 16 May, the Soviet military command in East Germany informed the Allied military liaison missions of new restrictions on their travel in

- On 15 November, the East Germans closed the Glienicker Bridge, the military liaison missions' primary transit point between West Berlin and their headquarters in Potsdam. Although it reopened the same day, the East Germans indicated that the bridge would be closed again if the West Berlin *Senat* did not agree to its terms for financing bridge repair and maintenance.

Show of Flexibility

More recent Soviet and East German actions, however, have allowed some progress to be made on two of these issues. Early in December, the Soviets notified a reservation for less than the full length of the air corridors, and shortly thereafter indicated to Allied officials in West Berlin that "most" of their future airspace reservations would be for less than the full length. In addition, the East Germans and the West Berlin *Senat* reached an agreement on the Glienicker Bridge in which the East Germans backed away from their earlier demand that West Berlin pay for future maintenance of the bridge. We do not believe the East Germans had an interest in coming to a quick agreement to keep the bridge open, and their retreat may have been at the behest of the Soviets.

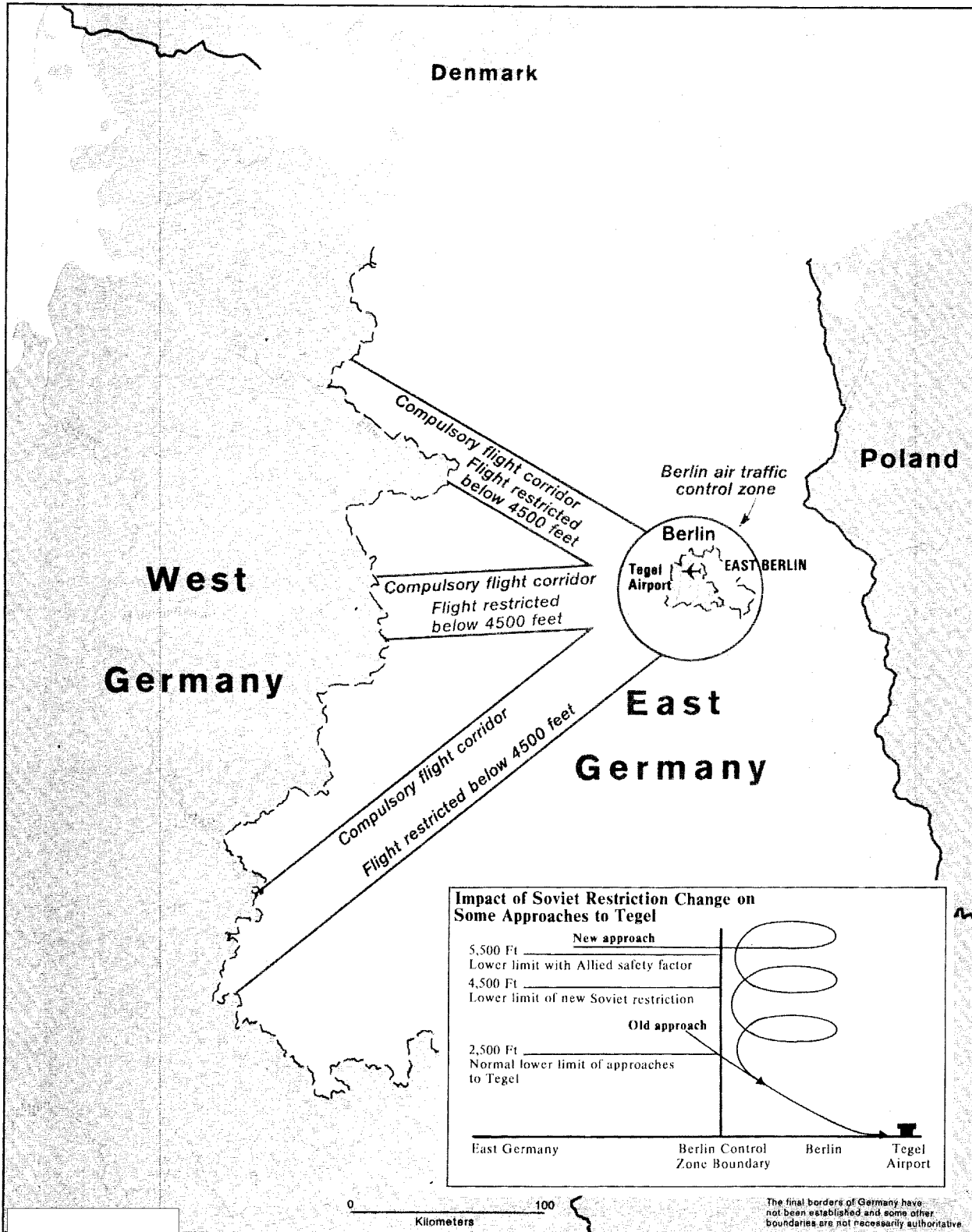
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Berlin Air Corridor Altitude Restrictions



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Despite these signs of Soviet flexibility, Moscow clearly has no intention of returning voluntarily to quadripartite management of the air corridors. The Soviets still are asserting the right to make unilateral adjustments in the Berlin air corridor regime, contrary to the Allied position that management of the corridors is a Four Power responsibility.

We believe that Soviet frustration with the failure of their efforts to block INF deployments contributed to the troubling actions on Berlin issues. The air corridor and travel actions taken last year have an inherent military rationale suggesting that recommendations by Soviet military commanders in East Germany—whose military requirements differ considerably from those that existed at the time the access understandings were established—have weighed heavily in Kremlin deliberations. For example, Soviet political authorities may have approved such recommendations as a convenient way to signal to the West the costs of increased East-West tensions.

Prospects for the Allies

The degree of Soviet and East German harassment to date almost certainly will not itself endanger the Western presence in Berlin; Western access has been inconvenienced but not reduced or explicitly threatened. Nonetheless, the Western position in and around Berlin has weakened. The problem is essentially one of an incipient erosion of access rights stemming from incremental steps by the Soviets and East Germans to change established practices. Whenever opportunities arise, the Soviets probably will continue to seek changes in the status quo, including Western acquiescence in their interpretation of the rules governing access to Berlin. They and the East Germans also will act to frustrate any improvement in the Western position or efforts to strengthen political ties between West Germany and West Berlin.

The West faces a difficult task in responding to Soviet and East German encroachments. The three Western powers sometimes are not in agreement on how to respond. Moreover, there would be little West European public sympathy for any Allied effort to escalate issues that could be perceived as minor—such as length of corridor reservations—into a major East-West confrontation.

The prospects for a settlement that restores full quadripartite management of the air corridors may increase if an East-West thaw leads Soviet authorities to decide the Berlin issue is not worth the potential damage to improved relations or if the West escalates its response to unilateral actions beyond verbal protests and presents the Soviets with new risks.

In evaluating threats to the Western position in Berlin, the West Germans sometimes present political and juridical problems for the Allies. The West Germans do not accept the Allied view that West Berlin is not legally a part of West Germany. Other activities by the West Germans, including their active pursuit of intra-German relations, sometimes have impinged negatively on status questions involving the Allies.

More serious Soviet challenges to the West in and around Berlin cannot be ruled out. The Kohl government's moves to increase the Federal Republic's ties to West Berlin are sharply criticized in Soviet propaganda and carry the risk of provoking a Soviet retaliation. At the moment, West Germany is a special target for Soviet hostility. A perceived Allied failure to contain assertive West German behavior could provide Moscow the pretext for further changes in the status quo in Berlin. Moreover, in the event that East-West relations do not develop favorably from Moscow's point of view or if US actions are perceived in Moscow as dangerous to important Soviet interests in regions less accessible to Soviet military power, Moscow might be tempted to exploit its inherent leverage over Western access to Berlin in more direct and threatening ways.



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West German Views on MBFR []

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During the 34th round of the Mutual and Balanced Force Reductions (MBFR) talks, last minute objections from the West Germans prevented the West from presenting a new package of "associated measures" to the East which were intended to increase confidence in and verifiability of an MBFR agreement. We think it is highly likely that officials in Bonn are reviewing West Germany's approach to the talks and that the West German Government may want to restructure the Western position. []

Background

Begun in 1973, the multinational bloc-to-bloc talks remain the sole arms control forum dedicated to conventional arms reductions in Europe. While the superpowers retain the decisive influence, their allies use the forum to express their own views at both formal sessions and in the corridors. The Western negotiating position is developed by the Senior Political Committee, made up of all NATO participants, but the substance of the Western position actually is hammered out during "trilateral" meetings among US, West German, and British representatives. []

Since 1976 the negotiations have been deadlocked by a disagreement over the number of Warsaw Pact troops in Central Europe. That year, the data presented by the Soviets fell 140,000 to 150,000 short of Western estimates. While various adjustments of the data have since narrowed the difference somewhat, the basic dispute remains. []

In order to gain some movement in the negotiations, the Allies have increasingly experimented with ways to demonstrate flexibility on the data issue and to refocus the talks on confidence-building "associated measures." The latter have included ground and aerial inspection of maneuvers, identification of entry and exit points for MBFR observers, and notification of certain out-of-garrison activities and movements of troops into and through the MBFR areas. Last April, for example, the West proposed that the United

States and the USSR undertake initial troop withdrawals of 13,000 and 30,000, respectively, without prior agreement on overall manpower levels in the MBFR zone. The West's willingness to undertake these cuts would be dependent on the Warsaw Pact's seriousness in negotiating an associated measures package. Future cuts leading to ceilings for both NATO and the Warsaw Pact of 900,000 ground and air forces (including 700,000 ground forces) would involve Allied forces and would require data agreement. []

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25X1**West German Views**

The West Germans have generally been the most conservative Western delegation at Vienna. They probably have not been entirely unhappy over the 11-year stalemate in the MBFR talks, largely because of their fear that an agreement would discriminate against their forces and interfere with West German sovereignty. In addition, West German leaders oppose any MBFR outcome that would weaken political support for maintaining Allied forces in West Germany. In particular, officials in Bonn—including Defense Minister Woerner and Foreign Minister Genscher—have complained that MBFR's jurisdiction zone (covering NATO forces in West Germany, Belgium, the Netherlands, and Luxembourg and Warsaw Pact forces in East Germany, Czechoslovakia, and Poland) is inherently unfair to West Germany; they have argued that, unlike the other major participants, the entire structure of their ground and air forces would be affected by an agreement. []

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so detailed that compromise within the Western delegation in the short time remaining before the end of the negotiating round proved impossible. [REDACTED]

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Despite Bonn's problems with MBFR, it does not want the negotiations to stagnate in part because of its desire to placate domestic advocates of arms control. Consequently, Bonn periodically floats initiatives designed to breathe life into the MBFR process on terms acceptable to West Germany. The West Germans, for example, were leading proponents of flexibility on the data issue last year, arguing that the West needed to make some gesture to demonstrate its commitment to arms control—especially after the furor over INF deployments and the Soviet walkout from negotiations on nuclear weapons. Moreover, last September the West German representative to MBFR emphasized that it was not possible to expect continued political support for an endless negotiation.

[REDACTED]

The Present Crisis

In exchange for flexibility on the data issue, the East has indicated that it is willing to agree to improved verification techniques in order to strengthen an MBFR agreement. The current impasse within NATO derives mainly from West German displeasure with the enhanced verification package Washington had hoped to present to the East during the last negotiation round. Specifically, the West Germans asserted that it was not necessary for the West to present a complete verification package during the last round. [REDACTED]

The West Germans have argued at meetings on MBFR that the verification package favored by London and Washington would allow Soviet and Warsaw Pact inspection teams too much freedom of movement in West Germany. In November a West German official at MBFR stated that Bonn would oppose any such verification scheme, even if it were acceptable to other NATO Allies or would benefit the West if applied to the Warsaw Pact. As a counter to that package, the West Germans proposed limiting the number of annual inspections for each side to 18 and limited inspections to certain military installations and training areas. Although West German officials assured the allies that their paper on inspections was not an effort to block progress, it was

Deeper Problems

We believe that Bonn's longstanding misgivings about MBFR could, in combination with other factors, lead to a fundamental reassessment of Bonn's role in the negotiations. In our view, these factors include Bonn's concern over the manpower shortages West Germany will be facing in the late 1980s and 1990s are the prospects for possible resubmission of the Nunn Amendment in the US Congress, the relationship of MBFR to the European Disarmament Conference, and the impending resumption of superpower negotiations on nuclear and space weapons. [REDACTED]

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Bonn's worries about its ability to sustain manpower levels for the armed forces probably is its major concern. On the surface, the prospect of manpower shortages in the 1990s would appear to be a motivation for West Germany to press for movement in MBFR. Bonn may, however, fear that an agreement could affect its plans to restructure its armed forces to compensate for the projected manpower shortfalls. In particular, the West Germans may worry that, under the 900,000/700,000 manpower ceilings, they would have to eliminate brigade-size units in the combat training reserve—an element of their forces that their ambassador to MBFR has already mentioned. [REDACTED]

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Prospects

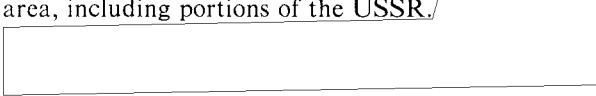
When the MBFR talks resume in early 1985, the West Germans probably will prefer that they continue with little movement until Bonn has a clearer picture of how to resolve its manpower problems and until the import for MBFR of resumed superpower arms control talks unfolds. Meanwhile, West German deliberations on MBFR are likely to go beyond the immediate question of inspections and embrace the substance of the West's negotiating position, perhaps including proposals to modify the agreed goal of reaching manpower ceilings of 900,000/700,000. The West Germans also may consider the benefits of incorporating the MBFR talks into the European Disarmament Conference negotiations. From Bonn's

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point of view, these talks—which now take place in Stockholm but will shift to Vienna in 1986—are less discriminatory because they cover a larger geographic area, including portions of the USSR./



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25X1 **Obstacles to Growth**

West German manufacturers have sustained losses in competitiveness over the past decade or so as a result of sluggish investment, slower productivity growth, and tardy adaptation to changing markets, especially in the high-technology sectors. While we expect West Germany to retain its standing as a major economic power behind the United States and Japan, the technological and structural gap that has opened will not be closed soon, and West Germany will have a hard time maintaining market shares at home and abroad.

Troublesome Trends

West German investment has been anemic since 1970. In real terms, it grew on average only 1.7 percent per year in the 1970s before falling off steeply during the recession years of the early 1980s. Among the Big Seven countries, only Italy and the United Kingdom did worse, while US and Japanese investment grew more than twice as fast. Real gross fixed investment in West Germany in 1983 was just 10 percent higher than the 1970 level, whereas Japanese, US, and French investment levels were up by 58, 45, and 28 percent, respectively.

Although West German manufacturing technology on the whole remains among the most advanced in the world, some key sectors have not kept pace with developments in Japan and the United States:

- In microelectronics, West Germany has been unable to develop a successful mainframe computer industry and has ceded its onetime dominance of the European consumer electronics market to France and Japan. It lags far behind the United States and Japan in the use of integrated circuits, and a major bottleneck exists in the field of software for information processing.
- In machine tools, West Germany has lost the technological supremacy it held in the 1960s, and its export market share has dropped 10 percentage points (equal to Japan's gain) since 1973. West

German engineers concentrated on refining machine designs with mechanical controls, while the Japanese were moving from mechanical to electronic controls—allowing for more flexibility in automating production.

- Japan is challenging West Germany in fiber optics, precision forging technology, medical electronics equipment, and advanced metalworking equipment.
- West Germany is also behind the latest developments in the new industrial fields of biochemistry, high-technology metals and materials, and advanced telecommunications.

Partly as a result of these factors, West Germany has seen its share of world nonoil exports drop from a high of 15 percent in 1970 to 13 percent in 1982. Although many Western countries have experienced trade share losses due to the export success of Japan and the newly industrializing countries, the impact is particularly hard on West Germany because exports account for one-third of West German GNP, the highest ratio in the Big Seven. In the most important industrial sectors—machine building, automotive manufacturing, chemicals, and electrical engineering—export-to-output ratios range up to 55 percent.

Factors Behind the Weakness

As these trends have persisted, business, labor, and government have all been given a share of the blame.

Overconfidence. The very success of West German industry in postwar decades is today a handicap to competing in a period of rapid technological change, according to industry observers. This view holds that West German industrialists developed an overconfident, even arrogant, attitude toward foreign competition after being successful for a long time with existing product lines.

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Labor's Role. A strong work ethic and rapid productivity growth resulting from investment and a highly qualified work force were prime factors underlying the postwar "economic miracle." Although impossible to quantify, the West German work force's reputation for dependability, hard work, and a superior product appears to be eroding. Along with sluggish investment and the aging of the capital stock, this probably contributed to the slowdown in productivity growth. West German output per worker rose only 2.6 percent in 1974-82, down from 4.4 percent in 1960-73.

Weak Financial Position of Firms. The long-term trend in profitability of West German firms has been downward for over a decade. During 1978-82, West German corporations averaged barely 7 percent in net return on equity capital; the French average was 8 percent; British and Japanese, 10 percent; and US, 14 percent. Poor profitability has clearly weakened the equity capital base of West German industry. The equity capital ratio¹ fell from 30 percent in 1967 to 18.5 percent in 1982, lessening the ability of business to undertake investment and withstand business reverses.

Bottlenecks. Complaints about administrative and other barriers to innovation and investment have multiplied since the mid-1970s. Business complaints about bureaucratic obstructions most frequently mention layoffs. To fire an employee without a legal proceeding is almost impossible, encouraging firms to avoid new hiring when business is good and to rely instead on overtime work. To close an unprofitable activity requires an onerous compensation plan for dismissed personnel that frequently causes firms to put off rationalization. In addition, West Germans as a matter of course look to the courts to adjudicate civil disputes that elsewhere would be settled by compromise or arbitration. Environmentalists also have blocked or delayed a number of power station and public works projects through legal and other means.

The Social Net. Extensive social welfare benefits—the highest per capita social benefits in the EC—may have weakened economic incentives. Social spending

now claims one-third of West German GNP, compared with 19 percent in the United States. Certain programs are particularly generous: tuition-free university education plus interest-free student loans, paid pregnancy leave of five months, unemployment compensation of up to 80 percent of aftertax salary for the first year, four-week visits to medical spas every three years, and theoretically unlimited paid sick leave.

Taxation. The burden of the social net is reflected in increasing taxes. The average worker will contribute over 40 percent of his income for taxes and social levies this year, and his marginal rate of taxation will be as high as 63 percent—compared with about 42 percent in 1965. In the Big Seven, only French taxes exceed West Germany's. For employers, high and growing contributions to government social programs put a tight squeeze on the profits of many companies, discouraging hiring and investment and contributing to the record number of bankruptcies.

Efforts To Respond to the Problem

West German government and business leaders are acutely aware of the obstacles to growth outlined above and are beginning to react:

- Overconfident attitudes on the part of West German economic leaders have been displaced, in our view, by readiness to learn from Japanese technology and US entrepreneurship. Joint ventures and other forms of technology exchange with Japanese and US firms are increasing, and the West German financial market is looking closely at the United States as a model for reforms.
- West German firms are trying to react more quickly to market developments, intensify R&D, and update product lines, looking in particular toward microelectronics.

The Kohl government also has taken some first steps to restructure industry, bolster competitiveness, revamp the cumbersome and expensive social welfare program, and stimulate lagging investment. It has given priority to reducing the budget deficits since assuming power two years ago, on the assumption that

¹ Capital stock plus reserves as a percent of total assets.

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fiscal consolidation would lower interest rates and revive investor confidence. Bonn also is playing a growing role in encouraging development of advanced manufacturing technology by coordinating and funding private R&D and calling attention to West Germany's high-technology gaps and successes.

In most areas, however, Kohl's policy of reducing state involvement in the economy and promoting a more market-oriented environment for West German firms has made little progress. Indeed, bureaucratic obstacles and the system of subsidies have increased under the Kohl government. And, after a bold start in trimming social programs, Bonn eased off in the face of labor union and other protests.

Outlook

Although a century of German industrial leadership will not dissipate quickly or easily, in our view, West Germany's high-technology gap will persist at least for the next several years. Given the accelerating pace of change in high technology, West Germany's own successes plus assimilation of foreign technology may leave it in the same relative place in the race. Even in the best of circumstances, the required changes in the conservative German business and social fabric will take time.

We expect that the Kohl government will not be inclined to push hard enough to achieve innovative change in economic policy:

- It probably will continue to be saddled with budget deficits viewed by West Germans as dangerous to price stability, though low by international standards.
- Kohl himself lacks economic expertise and has demonstrated his reluctance to ride herd over fractious coalition disputes.
- Economics Minister Martin Bangemann is new and inexperienced, and Finance Minister Stoltenberg is single-mindedly fixated on budget consolidation.

Indeed, even the modest success of the recovery will be a temptation not to press forward on the politically most contentious planks of the government's reform program, especially with Kohl and his party facing reelection in 1987.

Under these assumptions, our econometric model of the West German economy forecasts average annual real GNP growth for 1985-87 of 2.5 percent. Past



Economics Minister Martin Bangemann who replaced Count Otto Lambsdorff in June when Lambsdorff resigned because of his indictment on bribery charges.

sources of growth, investment, and exports will be present but less dynamic. The key obstacles to investment will continue to include (1) government inability to create an environment more conducive to business confidence; (2) high taxes and overgenerous social benefits that diminish incentives, and (3) socioeconomic factors that retard adaptation to changes in technology, finance, and marketing. As for exports, we expect West Germany to have a hard time maintaining its current trade share in an environment of intensified world competition.

A sluggish and less confident West German economy has serious implications for Bonn's relations with its West European neighbors and with the United States. In such conditions, the government would likely be:

- Reluctant to boost military spending and contributions to NATO programs.
- Resistant to measures that could jeopardize Eastern Bloc markets.
- Even more concerned about US budget deficits, interest rates, and the volatility of the dollar.
- Increasingly sensitive over bilateral trade differences.



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Restructuring the Steel Industry

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The planned merger between Kloeckner-Werke and Krupp, West Germany's second- and fourth-largest steel companies, is the first step toward a much needed consolidation of Western Europe's largest national steel industry. The new company, Krupp-Kloeckner Steel, will be able to close redundant, older facilities and to economize on distribution and raw materials costs. While backing Bonn's opposition to EC steel subsidies, the West German steel industry will demand matching subsidies if the influx of subsidized steel imports continues beyond next year. The Kohl government, however, is likely to continue its free market policies—pushing restructuring and shunning mass subsidies and protectionism.

Fighting To Recover

Foreign competition and sluggish demand dropped crude steel production from a peak of 53 million tons in 1974 to 36 million tons in 1983. During the period, West Germany lost market shares in intra-European trade and suffered in the US market from Japanese and South Korean competition. The independent Italian producers from the Brescia area were particularly aggressive in invading the West German market.

The merger agreement coincides with a fledgling recovery for the West German steel industry. Steel output in 1984—aided by robust export growth, especially to the United States—should rebound to 40 million tons. The volume of West German steel product exports rose at a 30-percent annual rate during the first half of the year as competitiveness was buoyed by the strong dollar. In addition, severe price discounting, which undermined sales revenues during the early 1980s, is disappearing because of higher demand and EC minimum price rules.

Modernization and work force reduction are permitting the West German mills to generate positive cash flows at utilization rates that are low by historical standards. Capacity utilization in the West German steel industry should average 66 percent this

year, compared to about 56 percent in 1983. In contrast, utilization rates were well above 80 percent in 1973-74. If operating rates continue to improve and prices hold up, West German steel companies could be in the black by 1985. After five consecutive years of losses, some mills are predicting break-even points by the end of this year. The metalworkers did not target steel during the 1984 strikes because of the precarious state of the industry.

West German steel has weathered a prolonged crisis, but at a heavy cost. We estimate that crude steel capacity has been cut 9 million tons—or roughly 15 percent—since 1979. The industry work force shrank from 169,000 in 1975 to 116,000 by the end of last year. The Kloeckner-Krupp merger will reportedly cut another million tons of crude steel capacity and eliminate 3,000 more jobs. Even so, more cuts are needed. German steel executives told US Embassy officials last summer that the industry must shed another 10-15 million tons of capacity to run at peak efficiency.

Steel Politics

The steelmakers blame much of their plight on the bureaucracies in Brussels and Bonn. They argue that the EC should force larger capacity cutbacks on the much more heavily subsidized steel industries of other European countries, and they want Bonn to enact stringent antidumping rules to keep out subsidized steel imports. At the same time, they complain that Bonn is too stingy with financial assistance.

According to the US Embassy, steelmakers also believe that the industry's inclusion under EC steel policy has disadvantaged West Germany's third-country trade

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The Kohl government has conflicting objectives. While recognizing the need to consolidate the industry, it is alarmed by high unemployment rates in the steel-producing regions, where important state and local government elections will be held next year. To ease the pain of restructuring, Bonn has made a fund of DM 3 billion (US \$1 billion) in adjustment assistance available to steelmakers seeking to rationalize production. The public money will partly offset the costs of reinvestment and termination and retraining for redundant workers. The steelmakers complain that the bulk of the fund is reserved for employee programs, while the new investment subsidies are available only on a matching contribution basis. Bonn has resisted industry demands for unilateral import restraints, but is pushing the other EC countries to honor their commitments to ban steel subsidies by yearend 1985. Industry leaders, however, are skeptical that other EC states will follow through on the no-subsidy pledge.

Bonn's own record on the subsidy issue is not entirely clean. The Kohl government has been willing to modify its free market orientation when faced with job losses in politically sensitive regions. For example, it recently approved, subject to EC concurrence, another injection of public money to keep the Arbed Saar steelworks solvent. Economically depressed Saar is one of the states holding elections next year, and Arbed generates one-third of all industrial jobs in the area. The opposition Social Democrats have promised government takeover of Arbed if—as seems likely—they win the elections.

Merger Activity

A much ballyhooed merger plan between Thyssen, Germany's largest steel producer, and Krupp disintegrated last year when Thyssen dismissed as inadequate Bonn's offer of DM 500 million (\$160 million) in special consolidation assistance. The Thyssen-Krupp merger would have been consistent

West Germany: Steel Production, 1982

Thousand metric tons

	Crude Steel	Rolled Steel
Total	35,880	30,796
Thyssen	10,915	10,223
Kloeckner-Werke	4,697	4,286
Hoesch	4,070	3,485
Krupp	3,991	2,644
Salzgitter	3,797	3,071
Arbed Saar	3,510	2,960
Dillinger	2,145	1,806
Edel	290	206
Other	2,465	2,115

with the recommendation of a panel of experts that German steelmaking be consolidated into two regional centers: a Thyssen-Krupp combine operating in the Rhineland and a Kloeckner-Hoesch-Salzgitter group operating in the Ruhr valley.

Instead, the Kloeckner-Krupp merger will be a functional consolidation. Krupp—West Germany's largest specialty steel producer—will concentrate on stainless and high-grade products, while Kloeckner will streamline its basic steelmaking operations. An Australian minerals and mining firm will receive an equity stake in the new venture reportedly in exchange for future iron ore supplies. The parent holding companies welcome foreign participation in the new company as a further means to divest their steelmaking operations. All the parties are pressing Bonn for startup assistance, but the government seems reluctant to raise the ante. This maneuvering may be tactical, but it introduces an element of uncertainty to the picture and may delay the effective date of the merger.

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Thyssen has indicated it is not actively seeking a merger partner, and will opt to consolidate by itself. Thyssen and the new Krupp-Kloeckner will together control over half of West German steelmaking. The remaining smaller companies will now be under increased competitive pressure to merge.

Outlook

Bonn will face hard choices over steel policy during the next several years. The steelmakers insist that their consolidation efforts will be undercut if subsidized imports continue. In September, They issued a position paper backing the government's opposition to an extension of EC steel subsidies into 1986; the paper also demanded, however, that Bonn provide matching subsidies if other EC members continue to aid their domestic steel industries beyond next year. Bonn realizes that expanded subsidies for steel would elicit demands for similar treatment from other declining industries and could provoke trade reprisals [redacted] Moreover, Bonn must decide what to do with Arbed Saarlust, which may need many more years of government assistance to stay afloat.

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The Kohl government is likely to continue its present policy of minimal interference, pushing the steelmakers to trim and modernize while shunning mass subsidization or import restrictions. Short of protectionism, Bonn has little leverage over other EC steel producers' continuing subsidies beyond next year. Bonn will probably seek compensation for its industry in the form of higher steel production quotas.

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**Western Europe: The Allies,
Arms Control, and SDI** []

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One Analyst's View



The Strategic Defense Initiative (SDI) could enhance Allied unity if coupled with a comprehensive proposal to reduce strategic arms. The West Europeans are likely to press for specific US arms control initiatives soon, and their concerns about decoupling will decline if they are convinced that SDI encompasses Washington's START, INF, and ASAT strategy. Coordinating SDI with conventional force improvements will be more difficult. []

Current Doubts

Allied skepticism toward SDI is based on the fear that the United States may try to protect its own population or strategic forces without equal regard for Western Europe's vulnerabilities. The Allies are concerned that SDI will not protect them from cruise and ballistic systems capable of striking West European targets after relatively short flights. They also fear that it will lead to a race in offensive arms that would bear out predictions that the umbrella will be inadequate before it is built: critics assume that the best conceivable arms control regime consists of SALT-like caps leaving huge residual offensive arsenals. []

In addition, some West Europeans believe that the United States will abrogate the ABM treaty. France and the United Kingdom, whose relatively small nuclear deterrents depend on an ABM-free environment, worry that their forces will be rendered obsolete by US and Soviet strategic defense programs, a prospect promising to make more difficult government efforts to ensure funding of strategic modernization programs. []

Building on the Zero Option

The INF experience may be relevant in constructing a successful arms control/public relations strategy, given likely Allied pressure for specific US arms control proposals after the Schultz-Gromyko meeting. Opposition to INF—in parliaments and some press organs—was undercut by the US zero option, an offer to forgo deployment on condition that the Soviets eliminate their I/MRBM force facing Europe. This proposal did not satisfy hardcore critics, but it did provide governments with an effective tool for shoring up parliamentary acceptance of the dual decision. The zero option convinced some West Europeans of US arms control sincerity and compared favorably to Moscow's fumbling mixture of freeze proposals and threats. []

A comprehensive initiative for dramatic reductions in ICBM, SLBM, LR- and SRINF systems would—like the zero option—put NATO on the arms control offensive and undercut fears of “decoupling.” Allied parliaments are likely to agree that probability of “leaks” in a defensive umbrella diminishes if SDI is coordinated with a priori reductions in strategic forces. In addition, SDI could help satisfy Allied verification concerns; polls indicate widespread West European public support for US insistence on adequate verification in arms control. Allied governments would probably believe that offensive breakout in a postreduction, SDI environment would require procurement levels so large as to make adequate monitoring likely. []

A specific SDI/arms control initiative would attract some editorial support, although critics would claim that the United States, expecting rejection from Moscow, hopes to use arms control rhetoric to mask its military buildup. Similar skepticism was evident regarding the zero option but did not detract from that proposal's overall public relations effectiveness. Soviet rejection of the proposal probably would damage the credibility of Moscow's call for "radical" solutions more than it would hurt perceptions that deep cuts are possible, especially in the long term. The favorable West European response to the President's recent UN speech is evidence that even some social democratic spokesmen accept US arms control sincerity. []

While INF negotiators met under the pressure of NATO's INF deployment deadline, future arms control delegations would have the years before SDI deployment to schedule deep cuts. There would even be time for a process in which US-Soviet reductions would be followed by a five-power nuclear disarmament conference as proposed by former Canadian Prime Minister Trudeau. []

The Nuclear Allies

An initiative envisioning deep cuts would satisfy London that SDI could render all strategic arsenals obsolete. Prime Minister Thatcher could claim that her Trident purchase is part of a strategy ensuring that Trident will need no successor. The long leadtime for SDI development makes it unnecessary that she forgo Trident itself. []

Paris's support for SDI—given its preoccupation with independent nuclear forces—is more problematic, but France cannot both insist on independence and expect a veto over Washington's strategic policy. Nevertheless, a proposal for deep cuts would meet French demands for US-Soviet reductions as a precondition for joining strategic talks. Paris has already shown an interest in SDI research and could envision an independent—if expensive—strategic defense in a postdeep-cut environment. []

SDI, ASAT, and the ABM Treaty

An integrated SDI/arms control approach would increase West European interest in banning antisatellite weapons because Allied support for

SDI—assuming they agree it can work—will depend on their faith in its stability. Ballistic missile defense is a confidence-building exercise only if the superpowers agree to forgo the capability of attacking SDI-related equipment (and somehow verify this abstention). The Allies are aware that the SDI umbrella itself will be inherently ASAT capable, and may suggest using "functionally related observable differences" to help create an ASAT-free regime. []

SDI and Conventional Forces

The Allies are unlikely to increase conventional defense spending significantly despite recent NATO agreements. It is doubtful that even a watertight SDI could convince them to do so even though, by nullifying the strategic threat, it could increase the danger of conventional military confrontation in Europe. A recent North Atlantic Assembly committee report complained that SDI will siphon off funds the United States would otherwise use for its own conventional capabilities. []

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Economic News in Brief

Western Europe

Foreign investment in France: Foreigners desiring to invest in France will find the **review process reduced** to at most one month as of 29 November . . . if a refusal has not been received in that time, approval is automatic . . . a member of Finance Minister Beregovoy's staff has indicated that the measure is designed to reduce the incorrect presumption that long delays are the norm in Europe and to speed up the bureaucracy. []

West German participation in US manned space station: Only remaining obstacle reportedly is **financing** . . . Bonn previously concerned that economic and political costs outweighed benefits . . . cabinet probably will make decision early this year. []

Spain's debt: Madrid prepaid \$975 million of public-sector loans in 1984 and intends to pay back another \$175 million before maturity in the first quarter of 1985 . . . reflects a sharp swing in Spain's current account from a \$2.5 billion deficit in 1983 to an expected surplus of about \$1.5 billion in 1984 and a heavy inflow of foreign exchange . . . a current account surplus again this year is likely and prepayments probably will be higher than Madrid's projection. []

Portugal's budget: Parliamentary debate will begin in mid-January . . . **coalition partners have agreed on a target deficit**, but not on specific measures . . . without substantial price hikes, revenue-raising, and expenditure-cutting measures, the target will be overshot. []

Turkish revenue bonds: Income-sharing bonds on the Bosphorus Bridge sold out within two hours last month, raising \$24 million for Ankara . . . the sale is part of Prime Minister Ozal's economic **program to privatize the economy** by selling off state-owned enterprises and infrastructure . . . selling industrial enterprises is likely to be more difficult, as many are unprofitable and the bureaucrats who manage them are likely to resist the reforms necessary to make them more efficient. []

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Eastern Europe

Hungary-International Monetary Fund: A high-level Hungarian contact of the US Embassy confirmed that **Budapest broke off negotiations with the IMF for a \$300 million standby loan** for 1985 . . . discord most likely resulted from reluctance to accept further austerity . . . the Hungarians are betting that Western bankers will interpret the lack of an IMF facility as a sign of financial health and thus continue to lend. []

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